

PROPOSED TESTIMONY OF THOMAS HERNDON, EXECUTIVE DIRECTOR OF
THE FLORIDA STATE BOARD OF ADMINISTRATION
PRESENTED TO THE SENATE COMMITTEE ON COMMERCE, SCIENCE
AND TRANSPORTATION AT THE MAY 16, 2002 HEARING

Thank you for this opportunity to comment on the “Enron disaster” and its implications for Florida State Board of Administration (“Florida SBA”) and other pension funds. The Florida SBA has a unique distinction in this situation, namely, that we lost more money on Enron stock than any other known organization. I can assure you that this is not a distinction that we relish. Approximately 90% of our Enron losses were realized in an account managed by Alliance Capital Management. So, for us at the Florida SBA, the current situation could more aptly be called “the Alliance disaster.”

Let me give you a brief background on who we are and how we operate. Briefly, the Florida SBA is the investment arm of Florida State government, with \$125 billion under management. The Florida SBA is governed by three members of the Florida Cabinet – the Governor, the Comptroller and the Treasurer. We invest the funds of approximately 25 government clients, with the largest being the Florida Retirement System at approximately \$100 billion. We are a broadly diversified investment organization with assets in the US stock market, US bond market, international stock market, real estate and private investments. The Florida Retirement System serves approximately 600,000 active members and 200,000 retirees. Under our defined benefits plan, payments due to retirees are guaranteed regardless of the gains or losses in the investment portfolio.

As a quick aside, I might add that we are currently in the midst of transitioning to a new Defined Contribution program, which might be of interest to the committee members at the point in time that you discuss privatizing Social Security.

Now, back to the main issue at hand – Alliance’s Enron investments for the

Florida Retirement System. Our Enron experience in Florida started in November, 2000 when Alliance first began to acquire a position in Enron. Our Domestic Equities unit has 14 outside money managers who are charged with exercising their expertise to select sound investments for our portfolio. Alliance was one of those 14 managers. These investment firms are given full discretion by contract, and are paid a handsome fee for the diligent deployment of their resources and expertise. In this case, the lion's share, by far, of our Enron position was acquired by Alliance Capital Management, and specifically their Minneapolis based large cap growth investment team headed by Al Harrison. Alliance's contract with the Florida SBA recognized Alliance's fiduciary duties and committed it to certain investment protocols, including the obligation to perform "rigorous company- specific research."

In this case, however, Mr. Harrison and Alliance failed to meet their obligations under our investment advisory agreement. Alliance's Enron purchases ultimately caused a principal loss of over \$280,000,000 to the Florida Retirement System. We believe Alliance was negligent in its job performance. As a result, we have filed litigation against Alliance to recover our losses. A copy of our Complaint has been furnished to this committee as an attachment to a copy of this statement.

We have all read stories about the inadequacy of Enron's financial disclosures, conflicts of interest at Enron as well as conflicts, which exist generally in the financial markets. While these subjects are worthy of your investigation, any investigative action you undertake should not allow financial professionals such as Alliance to shift the blame for their own negligence to the corporations in which they invest. As detailed in our Complaint, sufficient Enron information was publicly available to inform a sophisticated investment manager such as Alliance of the extreme risks of Enron investments. Remember, before Alliance even invested in Enron, the footnotes of Enron's financial statements disclosed the supposedly "secret" partnerships controlled by CEO Fastow. Sadly, Mr. Harrison has admitted, "nobody ever really dug into the footnotes."

Our concerns about Alliance’s investments in Enron coincided with our broader concern about Alliance’s performance for the Florida Retirement System. Alliance had suffered a period of poor performance unrelated to and before the Enron investments began. In 2000, we had put Alliance on a “watch list” where they stayed until terminated in December 2001. Throughout this period, in spite of continuing “red flags” that were raised associated with Enron’s death spiral, the Alliance investment team continued to buy Enron stock in an accelerated fashion. All of this is detailed in the Court Complaint, which we have furnished to you. You will note that Alliance kept buying, even though the Enron news was getting worse each day.

As we observed the Enron investments being made, we assumed, to our detriment, that Alliance was conducting the “rigorous company specific research” they had promised. When we questioned Alliance about the Enron purchases, we were assured of this fact. It is now clear to us that Alliance was buying Enron on “faith” – not on research. However, this hearing is not the place to try our case; that will be done later in court.

Rather, the Committee’s invitation to this hearing stated that the scope of your inquiry is focused on the practice of Enron officials contacting pension funds or institutional investors in order to tout Enron’s stock. We have no information to offer on this subject. We at the Florida SBA were never contacted by Enron officials. We were informed by Mr. Harrison that he and members of his Alliance team met with high-ranking Enron officials. We understand such contacts between corporate officials and large money managers are common and not unique to Enron nor Alliance. However, we at the Florida SBA have no direct knowledge about what was discussed between Enron and Alliance, or if these discussions were in any way different than those which commonly take place in the investment industry.

Much has been written about the conflicts of interest that surround Enron and Alliance, most notably, Mr. Frank Savage, who was an Enron Board Member (in fact

on the Finance Committee) while also serving as a senior officer and board member of Alliance. We have been assured by Alliance that this was a conflict without consequences. Because the effects of Mr. Savage's conflicts are unclear to us at this time, our lawsuit against Alliance currently makes no claims relating to Mr. Savage's conflicts of interest. We understand that this Committee, or others in Congress, are investigating conflicts in the investment industry. While we encourage a thorough review of these conflict practices, as a governmental body, the Florida SBA does not engage in the types of practices now under investigation.

One lesson that needs to be learned from this experience is that conflicts of interest in the public financial marketplace should at least be fully and openly disclosed, and some conflicts of interest should be prohibited altogether. Investment firms should install and enforce policies that prohibit investment firm employees from serving on boards of directors of firms they analyze. Just as it is inappropriate for accounting firms to be both auditor and consultant, or for investment bankers to not publish analytical reports on firm clients, it is inappropriate that board members of investment firms be on the boards of companies whose stock they are recommending and buying. There is simply too much opportunity for the wrong kind of alignment of interest.

In closing, I've tried to highlight what happened to us as a pension fund as a result of negligence on the part of Alliance Capital Management. As long as pension funds have active portfolio management, the pension industry must be able to rely on and fully trust expert outside financial advisors to exercise their fiduciary duties based upon independent research which is not compromised by conflicts of interest. Any actions you can take to ensure the integrity of the research and investment activities from Wall Street firms like Alliance Capital would be most worthwhile. Thank you for your attention, and I am happy to answer any questions.